MEMORANDUM

TO: CalPERS Investment Policy Subcommittee

DATE: October 20, 2008

FROM: Pension Consulting Alliance, Inc. (PCA)

RE: Divestment Policy Options

Introduction

CalPERS has become a global leader in corporate governance policies/practices that support the Board's fiduciary duty to act in the best interest of CalPERS members, and historically has preferred to address divestment issues by maintaining its holdings and advocating change within the companies rather than through divestment.

Consistent with this perspective, CalPERS has a highly evolved corporate governance constructive engagement process. The Global Principles of Accountable Corporate Governance provide a framework for CalPERS engagement, focus list and proxy voting practices. In addition, CalPERS has an Emerging Equity Markets Principles Policy that sets broad non-financial risk principles for managers to consider before investing in a given country or company. In addition to the above, the System is also a signatory to the United Nations Principles for Responsible Investment (UN PRI).

History suggests that divestment campaigns will continue to target large public pension funds such as CalPERS. In our opinion, divesting in response to non-financially determined campaigns may conflict with the fiduciary duty of pension fund trustees. At this juncture in time, PCA believes that it is appropriate for the Investment Committee to consider adopting an overarching investment policy framework on divestment. For the purposes of the Memorandum, divestment encompasses both selling existing securities and refraining from purchasing any new securities of a given company.

Background

Two important issues face public pension fund decision-makers in considering divesting.

1) **As to external divestment campaigns or laws, who controls the investments** – the Board of Trustees, the legislature or other governmental body?

2) **As to internal and external divestment initiatives, may the fiduciaries divest assets to help achieve social, etc. policy goals** without breaching their fiduciary obligations?

The California State Constitution provides a legal framework to address both issues. CalPERS has a fiduciary duty in regards to investing the fund. Under the California State Constitution; Article XVI, Sec. 17:

> The Board has the duty to administer the retirement system to provide benefits, defray reasonable expenses and minimize employer's costs, all in the interest of the participants and beneficiaries, and must do so by 'investing with care, skill, prudence and diligence.'
>
> The Legislature may by statute continue to prohibit certain Investments by a retirement board where it is in the public interest to do so, and provided that the prohibition satisfies the standards of fiduciary care and loyalty required of a retirement board pursuant to this section.[1]

As stated above, the California State Constitution answers the question of control and may allow the Legislature to prohibit certain investments where it is in the public interest, but provided that the prohibition satisfies the standards of fiduciary care and loyalty required of a retirement board.

The issue of control is also addressed as part of the CalPERS 2007-08 Federal Legislative and Regulatory Investment Policy Guidelines. With these guidelines, the CalPERS Board adopted a CalPERS Overarching Principle regarding independent fiduciary authority and guidelines on Fiduciary Authority. These principles and guidelines are assumed as part of the Policy Framework for the Policy Options below and are as follows:

Overarching Principles

- To preserve and enhance the independent fiduciary authority of institutional investors, to act for the exclusive benefit of their plan participants and beneficiaries;

Fiduciary Authority

- Support efforts to preserve the investment authority of plan trustees and administrators, and to act as independent fiduciaries on behalf of plan participants and beneficiaries.
- Oppose policies that restrict or direct investment options and decision-making such as any federally mandated investment restrictions or requirements.
- To not oppose Federal investment restrictions, provided that any restrictions be imposed consistently among all U.S. investors, in the event that the Federal government determines that an investment is not in the national interest of the United States of America.

As stated above, CalPERS guidelines further address the question of control and support the preservation of the investment authority of plan trustees and administrators as independent fiduciaries on behalf of the plan participants and beneficiaries.

The policy options below seek to address the specific issue of divestment, and the related question of engagement policies.

[1] This provision might only authorize the continuation of prohibitions in effect when this provision was added to the constitution.

Policy Options

This memorandum sets forth the three divestment policy options that PCA and Staff developed for the Investment Policy Subcommittee's consideration. Any divestment process is likely to be preceded by a process of shareowner engagement. Therefore, PCA and Staff developed two divestment related engagement policy options for the Subcommittee's consideration to adopt alongside the divestment policy. Either of the engagement policy options may be adopted in conjunction with any of the three divestment policy options. Upon the Subcommittee's direction regarding the policy direction, PCA and Staff recommend that Staff bring back formal policy language to the Policy Subcommittee.

<u>Divestment Policy Options</u>

The divestment policy options presented include:

1) Requires CalPERS to divest or underweight an investment in cases to the extent they conclude that continued ownership of the investment is no longer prudent, or, in the case of a new investment, would be imprudent.

2) Allows divestment if and only if suitable alternative investment can be found.

3) States that as a matter of policy, CalPERS does not divest except as required by law.

<u>Constructive Engagement Policy Options</u>

The constructive engagement policy options presented include:

1) A statement that the Investment Committee favors constructive engagement.

2) Normally will not engage in constructive engagement in divestment campaign-promoted situations except when required by law.

Divestment Policy Option Considerations

- Each Divestment Policy Option allows CalPERS to clearly address the divestment issue in an overarching investment policy that addresses divestment within the context of consistency with the fiduciary duties of the CalPERS Investment Committee.

- Any divestment program undertaken may involve significant costs, including transaction costs, opportunity costs and staff time in carrying out and monitoring the program.

- Policy Option 2 may cost significantly more than Policy Option 1 or 3 in terms of resources because it specifies a wider range of possible situations when divestment might be considered.

- Policy Option 2 may invite more external groups to come before the Investment Committee with divestment requests.

- Policy Option 2, if it results in divestment, may be inconsistent with CalPERS' position that the System has a greater voice if it "stays at the table" and engages.

- Policy Option 2 permits divestment subject to fiduciary safeguards. Divestment deliberations provided a forum for discussing and debating public policy issues.

- Policy Option 3 may be too inflexible to allow the Investment Committee to use all potential policy tools at its disposal.

- Policy Option 3 would likely be the least costly in terms of staff resources and have the least potential to encourange external groups to come before the Investment Committee with divestment issues.

Constructive Engagement Policy Options Considerations

Constructive engagement Policy options 1 and 2 differ in that the first option includes a general statement of the system's support for constructive engagement while Policy Option 2 normally permits divestment-campaign related engagement only when required by law. Constructive Engagement Policy Option 2 may be the least costly policy option in terms of resources devoted to engagement in divestment campaign related issues, however it appears to be inconsistent with the general CalPERS position that supports constructive engagement.

Policy Recommendations

Divestment Policy Option Recommendation: PCA and Staff recommend that the CalPERS Subcommittee adopt Divestment Policy Option 1 above to clearly address divestment issues in an overarching framework in a way that is both cost efficient, and likely to minimize demands on the System for divestment.

Constructive Engagement Policy Option Recommendation: PCA and Staff recommend that Engagement Policy Statement 1 may best complement Divestment Policy Option 1 because it supports CalPERS general constructive engagement framework.

APPENDIX: DRAFT General Language for All 3 Divestment Policy Options

The three divestment policy options share some proposed common language. To avoid repetition in each policy option, we have stated below the paragraphs common to all three divestment policy options, and included a bracketed segment where the distinct policy options should be inserted. The common policy language is as follows:

This policy governs how CalPERS will respond to divestment initiatives brought before the System.

CalPERS operates in a unique and complex social-economic milieu, and the Investment Committee expects corporations it invests in to meet a high ethical and social standard of conduct in their operations which, in the long-term, will result in superior investment performance. Importantly, CalPERS' ownership of securities in a corporation does not signify approval of all of a company's policies, products, or actions.

This policy is a matter of principle that is based on several considerations: (i) divestment would eliminate CalPERS' standing and rights as a shareowner and foreclose further engagement; (ii) divestment would likely be an ineffectual method of achieving the goals the divestment campaign is seeking to achieve, e.g., it is unlikely to have a material impact on divested companies or the market; (iii) divestment could result in increased costs and short-term losses; and (iv) divestment could compromise our investment strategies and negatively affect CalPERS' performance. For these reasons, we believe that divestment does not offer CalPERS an optimal strategy for changing the policies and practices of portfolio companies, nor is it the best means to produce long-term value for our participants.

[INSERT POLICY OPTION #1 , #2, or #3 SPECIFICS – SEE OPTIONS BELOW; IF OPTION #3 IS USED, DELETE THE BALANCE OF THIS SECTION.]

In such cases, the Investment Committee may direct investment staff to inform its equity investment managers that the managers shall dispose of the interest (or avoid investing) in the company and invest in the alternative(s) until such time as the reasons that led to divestment have been remedied.

Investment staff shall advise the Investment Committee when and if the corporate situation that triggered CalPERS' divestment has been remedied. Upon the Subcommittee's concurrence that the situation that caused divestment has been remedied, the Investment Committee will direct its investment staff to promptly inform the equity investment managers that the securities can thereafter be purchased and report such action in writing to the Investment Committee.

Policy implementations should be reviewed on a regular basis.